537/990

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Installment Sales

For use in preparing
1990 Returns

Introduction

An installment sale is a sale of property where one or more payments on the sale is to be received after the close of the tax year. If you finance the buyer's purchase of your property yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. However, you do not have an installment sale if the buyer gives a deed of trust or mortgage to a bank or trust company and then pays you the total selling price. If a sale qualifies as an installment sale, you must report the sale on the installment method unless you elect to recognize gain on the sale in accordance with your regular method of accounting. Under the installment method you report the gain on the sale only as payments are received. It does not matter whether you use the cash or accrual method of accounting.

This publication is divided into two parts:

- General Rules. The first section discusses the basic rules that apply to all installment sales.
- Other Rules. The second section (beginning on page 4) discusses the more complex rules that apply only when certain conditions exist or when certain types of property are sold.

If you sold nonbusiness property, such as your home, under an installment plan, you should need only the general rules. If you sold property for which you have claimed depreciation deductions, such as business or rental property, you should also read the discussion of depreciation recapture in the second section.

If you sell your entire interest in a passive activity on the installment method, special rules apply to the treatment of passive activity losses. For more information, see Publication 925, *Passive Activity and At-Risk Rules.*

Free Publications and Forms

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General Rules

The buyer's "installment obligation" to make future payments to you might be in the form of a deed of trust, a note, a land contract, a mortgage, or some other evidence of the buyer's indebtedness to you. The rules discussed in this publication apply regardless of the form of the installment obligation.

Dealer sales. Sales of personal property by a dealer or anyone else who regularly sells property on the installment plan cannot be reported on the installment method for federal income tax purposes. This also applies to real property that is held for sale to customers in the ordinary course of the trade or business. However, this does not apply to a sale on the installment plan of any property used or produced in the trade or business of farming.

Special rule. Dealers of timeshares and residential lots can report sales on the installment method if they elect to pay interest on the installment obligations from these sales. For more information see section 453(l) of the Internal Revenue Code.

Sale at a loss. If your sale results in a loss, you may not use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of the sale. You cannot deduct a loss on the sale of property owned for personal use.

If your sale calls for payments in a later year, and there is little or no interest provided for in the contract of sale, you may have to figure unstated interest even though you have a loss. See the discussion of unstated interest later in this publication.

Figuring Installment Income

Each payment on an installment sale usually consists of three parts:

1) Return of your investment (basis) in the property sold,
2) Gain on the sale, and
3) Interest.

Each year that you receive payments, you must include in income the interest part of the payment and the part of the payment that is your gain. You do not include in income the part of the payment that is the return of your basis in the property sold.

Interest income. If interest is included in a payment, you must report separately all the interest as ordinary income on your income tax return. Interest is generally not included in a down payment. However, you may have to treat a part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See the discussion of unstated interest, later.

Gain. The rest of each payment is treated as if it were made up of two parts. One part is a return of your investment (basis) in the property you sold. The other part is your gain from the sale. The gain will be capital gain if the property you sold was a capital asset. However, if you took depreciation deductions on the asset, part of your gain may be treated as ordinary income. See the discussion of depreciation recapture income under *Other Rules*, later.

To determine what part of a payment is gain (profit), you must first determine the gross profit percentage. The gross profit percentage is figured by dividing the gross profit on the sale by the contract price. The following worksheet, which is based on Form 6252, *Installment Sale Income*, gives the basic items you must know to figure the gross profit percentage.

1) Selling price		_____
2) Minus the sum of:		
Basis of property sold	_____	
Selling expenses	_____	_____
3) Gross profit (line 1 less line 2)		_____
4) Contract price		_____
5) Gross profit percentage (line 3 divided by line 4)		_____

The following paragraphs discuss in detail each item of the above worksheet.

Selling price. The selling price for an installment sale is the entire cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. It also includes any debt the buyer pays, assumes, or takes the property subject to. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. You cannot go back and refigure the gain you reported in earlier years.

Example. In 1988, you sold land with a basis of $40,000 for $100,000 and have a gross profit of

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$60,000. You received a $20,000 down payment and the buyer's note for $80,000. The note payments are $20,000 each, plus 12% interest, beginning in 1989. Your gross profit percentage is 60%. You reported a gross profit of $12,000 on the payments received in 1988 and 1989. In 1990, you and the buyer agree to reduce the purchase price to $85,000 and the payments during 1990, 1991, and 1992 are reduced to $15,000 for each year.

Your adjusted gross profit on the sale is $45,000. You subtract the total amount of profit reported in 1988 and 1989, or $24,000, from the adjusted gross profit to determine the remaining profit to be reported. The remaining profit of $21,000 to be reported is divided by the selling price to be received of $45,000 ($85,000 − $40,000) to get the new gross profit percentage of 46.67%. You will report a gross profit of $7,000 on each of the $15,000 installments due in 1990, 1991, and 1992.

Basis and adjusted basis. Basis is a way of measuring your investment in the property you are selling. The way you figure basis depends on how you first acquired the property. The basis of property you bought is usually its cost to you. The basis of property you inherited, got as a gift, built yourself, or received in a tax-free exchange must be figured differently.

While you own personal use property, various events may change your original basis in the property. Some events, such as additions or permanent improvements, increase basis. Others, such as deductible casualty losses, decrease basis. The result is ***adjusted basis.***

For more information on how to figure basis and adjusted basis, see Publication 551, *Basis of Assets.*

Installment sale basis. The adjusted basis plus selling expenses and depreciation recapture income (discussed under *Other Rules*) is referred to in this publication as the installment sale basis.

Selling expenses. Selling expenses are the expenses that relate to the sale of the property. They include commissions, attorney fees, and any other expenses that are paid in connection with the sale. Add the selling expenses to the basis of the property sold in determining the gross profit on the sale.

Gross profit. For an installment sale, gross profit is the amount of gain you report on the installment method.

To figure your gross profit, you must know your adjusted basis in the property you sold and the selling price. You add the commissions and other expenses paid in connection with the sale to your adjusted basis. Then subtract the adjusted basis, as increased, from the selling price to determine gross profit. If the property you sold was your home, subtract from the gross profit any gain you can postpone or exclude. The result is your gross profit from the sale.

Contract price. The contract price is the total amount of all the principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments*, later.

If the selling price is payable partly in cash, with the remainder secured by a mortgage payable from the buyer to you, then the contract price equals the selling price.

Gross profit percentage. A certain percentage of each payment (after subtracting out interest) must be reported as gain from the sale. This percentage usually remains the same for each payment you receive. It is called the "gross profit percentage," and is figured by dividing your gross profit from the sale by the contract price.

Example. You sell property at a contract price of $2,000, and your gross profit is $500. Your gross profit percentage is 25% ($500 divided by $2,000). After subtracting out interest, 25% of each payment, including the down payment, is reported as your gain from the sale for the tax year the payment is received.

Income from sale. Each year that you receive a cash payment on the installment sale, you multiply the payment (less interest) by the gross profit percentage to determine the amount you must include in income for the tax year. In certain circumstances, you may be considered to have received a payment even though you actually receive nothing directly. In addition to the receipt of cash, a receipt of property or the assumption of your mortgage on the property sold may be considered a payment. For a detailed discussion, see *Payments* under *Other Rules*, later.

Reporting installment sale income. You must use Form 6252 any time you have a sale of property that you report as an installment sale. The form is used to report the sale in the year it takes place, and to report payments received in later years.

Form 6252 will help you determine the gross profit, contract price, gross profit percentage, and how much of each payment you receive during the tax year on the sale that is included in income.

Form 6252 is made up of three parts:

1) Part I, *Figure the Gross Profit and Contract Price,* must be completed for the year of sale.
2) Part II, *Figure the Taxable Part of Installment Sale,* must be completed for the year of sale and for any year in which you receive a payment or are considered to have received a payment.
3) Part III, *Figure the Taxable Part of Related Party Installment Sale,* must be completed if you sold the property to a related person as discussed later under *Installment Sales to Related Persons.*

Year of sale. Answer the questions at the beginning of the form and complete Part I and Part II. Question D asks whether you sold the property to a related party. If you answer "Yes" to question D, answer question E and complete Part III.

Later years. Answer the questions at the beginning of the form and complete Part II for each year in which you receive a payment on the sale. If you sold the property to a related person, you may have to complete Part III also.

Schedule D. The gain figured on Form 6252 for personal use property must be carried over and entered on Schedule D (Form 1040) *Capital Gains and Losses.* Each year you must include on Schedule D the capital gain part of the payments reported on Form 6252.

If your gain from an installment sale qualifies for long-term capital gain treatment in the year of sale, it will continue to qualify in later tax years. Your gain will be long-term if you owned the property for more than one year when you sold it.

Sale of home. If you sell your home, you may be able to postpone or exclude all or part of the gain on the sale. See *Gain or Loss,* and *Exclusion of Gain,* in Publication 523, *Tax Information on Selling Your Home.* If the sale is an installment sale, any gain you may postpone or exclude is not taken into account. Therefore, you figure your gross profit percentage by including in gross profit only the part of the gain that is not postponed or excluded.

Sample Form 6252

The following example illustrates how to fill out Form 6252 for the year of the sale. This example includes a filled-in Form 6252 that applies the general rules discussed in this part of the publication to the sale of a home. There are two more sample filled-in forms at the end of the publication.

Example. On May 30, 1990, John Cabin sells his home for $75,000, under terms that permit him to use the installment method. The sale agreement provides for payments of interest each December at an annual rate of 12% in addition to the payments on the sale price. His adjusted basis in the property is $54,000 and he has selling expenses of $4,500 for a total of $58,500. He, therefore, has a gain of $16,500 on the sale ($75,000 − $58,500). He buys another house, postponing the tax on $9,000 (line 15 of Form 2119) of his gain. He figures the gross profit using only the taxable part of the gain, $7,500 ($16,500 − $9,000). His gross profit percentage is 10% ($7,500 taxable gain divided by $75,000 contract price). He reports the interest payments as ordinary income on Form 1040. He received only a down payment of $20,000 during 1990. In addition he received the buyer's note for $55,000 with payments to begin in 1991.

John fills out Form 6252 for 1990 as follows:

Question A. John writes in a description of the property sold.

Questions B and C. John enters the date he acquired the home and the date he sold it.

Question D. John did not sell the home to a related party, he checks the "No" box.

Part I. John uses this part of the form to figure the contract price and his gross profit on the sale.

Line 1. John enters the selling price of $75,000.

Line 2. The buyer did not assume the mortgage on the home, therefore, John enters nothing on this line.

Line 3. John enters the $75,000.

Line 4. John enters his basis of $54,000.

Lines 5 and 6. John did not take depreciation deductions on the home, the amount on line 4 carries over to line 6.

Line 7. John's only selling expense was a commission of $4,500 (6% of $75,000).

Line 8. Since no depreciation was claimed, John has no income recapture.

Line 9. The total of John's basis in the property plus his selling expenses is $58,500.

Line 10. John subtracts line 9 from line 1 and enters the result, $16,500.

Line 11. John enters $9,000, the part of the gain that he can postpone.

Line 12. John subtracts line 11 from line 10 and enters the result, $7,500.

Line 13. John enters zero.

Line 14. The contract price, $75,000, is the sum of all the payments John will receive on the sale.

Part II. In this part John figures the amount of gain from the sale he must report for 1990. In any later year during which he receives a payment on this sale, this is the only part of the form that John will have to fill out.

Line 15. John's gross profit percentage for the sale is the gross profit on line 12, $7,500, divided by the contract price on line 14, $75,000, or 10%.

Line 16. John enters zero.

Line 17. The only payment John received during 1990 was the down payment of $20,000.

Line 18. John enters $20,000.

Line 19. Since 1990 is the year of sale, John makes no entry here.

Line 20. The gross profit percentage (line 15) is 10%. Therefore, John enters 10% of $20,000 (line 18) or $2,000.

Lines 21 and 22. Since John sold undepreciated property, he does not have to recapture any depreciation deductions as ordinary income. He carries the amount on line 22 to line

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ See separate instructions. ▶ Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228

1990

Attachment Sequence No. 79

Name(s) shown on tax return: John Cabin

Identifying number: 566 - 00 - 3263

A Description of property ▶ House and Land

B Date acquired (month, day, and year) ▶ 9 / 15 / 83 C Date sold (month, day, and year) ▶ 5 / 30 / 90

D Was the property sold to a related party after May 14, 1980? (See Instructions.) ☐ Yes ☑ No

E If the answer to D is "Yes," was the property a marketable security? (If "Yes," complete Part III. If "No," complete Part III for the year of sale and for 2 years after the year of sale.) ☐ Yes ☐ No

Part I Gross Profit and Contract Price *(Complete this part for the year of sale only.)*

1	Selling price including mortgages and other debts. (Do not include interest whether stated or unstated.)		1	75,000
2	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	2		
3	Subtract line 2 from line 1	3	75,000	
4	Cost or other basis of property sold	4	54,000	
5	Depreciation allowed or allowable	5	-0-	
6	Adjusted basis. Subtract line 5 from line 4	6	54,000	
7	Commissions and other expenses of sale	7	4,500	
8	Income recapture from Form 4797, Part III. See Instructions	8	-0-	
9	Add lines 6, 7, and 8		9	58,500
10	Subtract line 9 from line 1. If zero or less, do not complete the rest of this form		10	16,500
11	If the property described in question A above was your main home, enter the total of lines 9g and 15 from Form 2119. Otherwise, enter -0-		11	9,000
12	Gross profit. Subtract line 11 from line 10		12	7,500
13	Subtract line 9 from line 2. If zero or less, enter -0-		13	-0-
14	Contract price. Add line 3 and line 13		14	75,000

Part II Installment Sale Income *(Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.)*

15	Gross profit percentage. Divide line 12 by line 14. (For years after the year of sale, see Instructions.)		15	.10
16	**For year of sale only**—enter amount from line 13 above; otherwise, enter -0-		16	-0-
17	Payments received during year. See Instructions. (Do not include interest whether stated or unstated.)		17	20,000
18	Add lines 16 and 17		18	20,000
19	Payments received in prior years. See Instructions. (Do not include interest whether stated or unstated.)	19		
20	Installment Sale Income. Multiply line 18 by line 15		20	2,000
21	Part of line 20 that is ordinary income under recapture rules. See Instructions		21	-0-
22	Subtract line 21 from line 20. Enter here and on Schedule D or Form 4797		22	2,000

Part III Related Party Installment Sale Income *(Do not complete if you received the final payment this tax year.)*

F Name, address, and taxpayer identifying number of related party

G Did the related party, during this tax year, resell or dispose of the property ("second disposition")? ☐ Yes ☐ No

H **If the answer to question G is "Yes," complete lines 23 through 30 below unless one of the following conditions is met (check only the box that applies).**

☐ The second disposition was more than two years after the first disposition. If this box is checked, enter the date of disposition (month, day, year) ▶

☐ The first disposition was a sale or exchange of stock to the issuing corporation

☐ The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition

☐ The second disposition occurred after the death of the original seller or buyer

☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See Instructions

23	Selling price of property sold by related party	23	
24	Enter contract price from line 14 for year of first sale	24	
25	Enter the **smaller** of line 23 or line 24	25	
26	Total payments received by the end of your 1990 tax year. Add lines 18 and 19	26	
27	Subtract line 26 from line 25. If zero or less, enter -0-	27	
28	Multiply line 27 by the gross profit percentage on line 15 for year of first sale	28	
29	Part of line 28 that is ordinary income under recapture rules. See Instructions	29	
30	Subtract line 29 from line 28. Enter here and on Schedule D or Form 4797	30	

11 of Schedule D (Form 1040) where it is included with any other long-term capital gains he may have.

Other Rules

The rules discussed in this part of the publication apply only in certain circumstances or to certain types of property. The rules discussed cover:

Electing out,
Payments,
Escrow accounts,
Depreciation recapture income,
Installment sales to related persons,
Like-kind exchanges,
Contingent sales,
Single sale of several assets,
Installment sale of a business,
Unstated interest,
Dispositions of installment obligations,
Repossessions, and
Reporting an installment sale.

Electing Out

You can choose not to have the installment sale rules apply to your sale. If you make this choice, you must report your entire gain from the sale on your return for the year of sale, even though you will not be paid all of the selling price until later.

Selling price. To figure the selling price under this method, you must figure the buyer's installment obligation to you at its fair market value. Notes, mortgages, and land contracts are examples of obligations that must be included at fair market value in figuring the selling price. If you do not elect out, these obligations would be included at their full face value.

Example. You sold a parcel of land to another person for $50,000, payable $10,000 down and the balance over a period of 10 years at $4,000 a year, plus 12% interest. The buyer gave you a note for $40,000. The note had a fair market value of $30,000 (75% of its face value). You paid a commission of 6%, or $3,000, to a broker for negotiating the sale. The land cost you $25,000 and you owned it for more than one year. You decide to elect out of the installment method, and report the buyer's note at its fair market value.

Computation of gain:		
Selling price		$50,000
Minus: Adjusted basis of the property	$25,000	
Commission	3,000	28,000
Gain realized		$22,000

Gain recognized in year of sale:		
Cash		$10,000
Market value of note (75% of $40,000)		$30,000
Total realized in year of sale		$40,000
Minus: Adjusted basis of the property	$25,000	
Commission	3,000	28,000
Gain recognized in year of sale		$12,000

The $12,000 is long-term capital gain. However, since you included only the fair market value of the note (75% of face value) to figure the gain recognized in the year of sale, you must report as ***ordinary income*** 25% of each payment of principal you receive in later years (25% x $4,000 = $1,000). The interest on the note also is ordinary income and is reported as interest income on Form 1040.

Fair market value. If you elect out of the installment method, you must figure the fair market value of the buyer's installment obligation to you, whether or not you would actually be able to sell it. If you use the cash method of accounting, the fair market value of the obligation will never be considered to be less than the fair market value of the property sold (minus any other consideration received). If you use an accrual method of accounting, you must always use the full face value of the installment obligation as its fair market value when you elect out.

How to elect out. To make this choice, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever is appropriate.

If you elect out and also value the buyer's installment obligation at less than its face value, you must complete an additional part of Schedule D (Part V) or Form 4797 (Part IV). Check the box provided in that part of the form, and enter the face amount of the buyer's obligation to you and the percentage of the face amount that you are reporting in the year of sale.

When to elect out. You must make the election not to have the installment sale rules apply by the due date, including extensions, for filing your tax return for the year in which the sale takes place. Once made, the election generally cannot be changed. However, you can apply to revoke your election not to use the installment sale rules. A revocation of the election will not be permitted when one of its purposes is the avoidance of federal income tax, or when the tax year in which any payment was received has closed.

Payments

You must figure your profit on the payments you receive, or are treated as receiving, each year from an installment sale, including the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you will be considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer takes over or pays off any of your debts, such as a loan, or any of your expenses, such as a sales commission.

Buyer's note. The buyer's note (unless it is payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. The payments you receive on the note are reported on the installment method.

Buyer assumes expenses. If the buyer assumes and pays expenses you have in connection with selling your property, it is considered a payment to you in the year of sale. The expenses are included in both the selling price and contract price when figuring the gross profit percentage.

Mortgage assumed. If the buyer assumes (or pays off) your mortgage, or otherwise takes the property subject to it, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered a payment to you. The contract price equals the selling price minus the amount of the mortgage. This difference is all that you will directly collect from the buyer.

Example. You sell property with an adjusted basis to you of $19,000, and you have selling expenses of $1,000. The buyer assumes your existing mortgage of $15,000 and, in addition, agrees to pay you a total of $10,000, a cash down payment of $2,000 and $2,000 (plus 12% interest) in each of the next 4 years.

The selling price is $25,000 ($15,000 + $10,000). The contract price is $10,000 ($25,000 − $15,000 mortgage). Your gross profit is $5,000 ($25,000 − $20,000 installment sale basis), and your gross profit percentage is 50% ($5,000 divided by $10,000). Therefore, you must report half of each $2,000 payment you receive as gain from the sale. You must also report all of the interest you receive as ordinary income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The portion in excess of your basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually receive from the buyer. To this amount add the "payment" you are considered to receive (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale. Therefore, if the mortgage the buyer assumes is equal to or more than your installment sale basis in the property, the gross profit percentage will always be 100%.

Example. The selling price for your property is $9,000. The buyer will pay you $3,000 (plus 12% interest) over the next 3 years, and also assumes an existing mortgage of $6,000. Your adjusted basis in the property is $4,400 and you have selling expenses of $600, for a total installment sale basis of $5,000. The part of the mortgage that is more than your installment sale basis is $1,000 ($6,000 − $5,000). This amount is included in the contract price and is also treated as a payment you receive in the year of sale. The contract price is $4,000 ($9,000 − $6,000 + $1,000).

Your gross profit on the sale is also $4,000 ($9,000 − $5,000). Therefore, your gross profit percentage is 100%. As the buyer pays you the $3,000, you must report 100% of each payment as gain from the sale. You must also treat the $1,000 difference between the mortgage and your installment sale basis as a payment, and report 100% of it as gain in the year of sale.

Wraparound mortgages. If your mortgage is not paid off or assumed by the buyer when you sell your property, your installment arrangement with the buyer may be known as a "wraparound mortgage." In a wraparound mortgage, the installment payments you receive are ordinarily large enough to allow you to continue to make your regular mortgage payments on the property.

The treatment of a wraparound mortgage depends on control of the proceeds paid by the buyer. Depending on the circumstances, a wraparound mortgage may be treated as though the buyer had assumed your mortgage. It would not matter that you are still liable for the mortgage or that title to the property has not actually changed hands.

Mortgage canceled. If the buyer of your property is the person who holds the mortgage on it, your debt is canceled. It is not assumed. It is canceled. You are considered to receive a payment equal to the outstanding amount of the canceled debt.

Example. Mary Jones loaned you $4,500 in 1986 in exchange for a note mortgaging a tract of land you owned. On April 4, 1990, she bought the land for $7,000. At that time, $3,000 remained outstanding on her loan to you. She agreed to forgive this $3,000 debt and to pay you $2,000 (plus interest) on August 1, 1990, and $2,000 (plus interest) on August 1, 1991. Mary did not assume an existing mortgage. She canceled the $3,000 debt you owed her. The effect is that you received a $3,000 payment at the time of the sale.

Debts. If the buyer pays off any of your debts, such as a loan or back taxes, it may be considered a payment to you in the year of the sale.

If the buyer assumes the debt instead of paying it off, only a part of it may have to be treated as a payment. Compare the amount of the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. This follows the same rules discussed above under *Mortgage assumed.*

However, these rules apply only to two types of debts that the buyer assumes:

1) Those that you acquired in connection with your ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes, and
2) Those that you acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated the same as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to you in the year of the sale.

Payments of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Like-Kind Exchanges,* later. The value of the payment is the property's fair market value on the date you receive it.

Fair market value. This is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its fair market value.

Third-party notes. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's fair market value. Because the note is itself a payment on your installment sale, any payments you later receive on the note from the third party are not considered payments on your sale. If the fair market value of the note was less than its face value, a part of each payment you receive on it must be reported as ordinary income.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a $5,000, 12% note of a third party. The fair market value of the third-party note at the time of your sale was $3,000. This amount, and not $5,000, is a payment to you in the year of sale. Because the third-party note had a fair market value equal to 60% of its face value ($3,000 divided by $5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. The interest you receive is reported in full as ordinary income.

Bonds. A bond or other evidence of indebtedness you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received a payment equal to the bond's fair market value. Accrual basis taxpayers, see section 15A.453-1(e)(2) of the regulations.

Guarantees. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered to be a payment.

Deposits. Deposits that you receive before the year of sale should be treated as payments in the year of sale if, under the contract, they become part of the down payment.

Installment obligation used as security (pledge rule). If you use an installment obligation to secure any debt, the net proceeds from the debt are treated as a payment on the installment obligation. This is known as the pledge rule. The pledge rule applies to sales of certain property whose sales price was more than $150,000. It does not apply to the sale of:

Property used or produced in the trade or business of farming,

Personal use property.

The net debt proceeds are the gross amount of the debt minus the direct expenses of getting the debt. The amount treated as a payment is considered received on the later of:

1) The date the debt becomes secured, or
2) The date you receive the proceeds of the debt.

A debt is secured by an installment obligation to the extent that the payment of principal or interest on the debt is directly secured under the terms of the loan, or any underlying arrangement, by an interest in the installment obligation.

Limits. The amount treated as a payment on the pledged installment obligation cannot be more than the excess of:

1) The total contract price on the installment sale, over
2) Any payments received on the installment obligation before the date the amount is treated as a payment.

Exception. The pledge rule does not apply if the debt is incurred after December 17, 1987, to refinance a debt that was:

1) Outstanding on December 17, 1987, and
2) Secured by that installment sale obligation on that date and at all times thereafter until the refinancing.

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt if the refinancing is provided by a person other than the creditor or a person related to the creditor.

This exception applies only to the amount of the refinancing that does not exceed the principal amount of the original debt immediately before the refinancing. Any excess amount is treated as a payment on the installment obligation.

Reporting the payment. Include the amount treated as a payment received on the installment sale on line 17 of Form 6252. The payments less any interest you receive on the installment obligation after it is pledged as security will not be included as payments on the obligation until the total payments actually received are more than the amount treated as a payment as a result of the pledge. The interest received must be reported on Form 1040. The total amount of gain that must be included in income because of the pledge rule and payments received cannot be more than the total gain determined for the installment sale.

Escrow Accounts

In some cases, the sales agreement, or a later agreement, may call for the buyer to establish an irrevocable escrow account out of which the remaining installment payments (including interest) are to be made. Generally, these sales may not be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When an escrow account is established, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

Example. You sell property for $10,000. The sales agreement calls for a down payment of $1,000 and payment of $1,500 in each of the next 6 years to be made from an irrevocable escrow account containing the balance of the purchase price plus interest. You may not report the sale on the installment method because the full purchase price is considered to have been received in the year of sale. You must report all your gain in the year of sale.

Escrow established in a later year. If you make an installment sale and in a later year an irrevocable escrow account is established to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation. Therefore, you cannot use the installment method to report any payments you receive from the escrow account. This is because a disposition has occurred. See *Dispositions of Installment Obligations,* later.

Substantial restriction. If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale may be reported on the installment method, provided it otherwise qualifies. In order for an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer.

Example. You sell your business including all of its assets for $50,000. The sales agreement provides for a down payment of $8,000 and payments of $7,000 in each of the next 6 years to be made from an irrevocable escrow account. The sales agreement also provides that you, the seller, will not enter a competing business for a period of 6 years. If at any time during this period you enter a competing business, you will forfeit all rights to the amounts then held in escrow. In this situation, the escrow arrangement imposes a substantial restriction and you can use the installment method.

Depreciation Recapture Income

If you sell on the installment method property for which you claimed depreciation deductions, you must report any depreciation recapture income in the year of sale. You figure your depreciation recapture income (including the ***section 179 deduction*** recapture) in Part III of Form 4797. Report the recapture income in Part II of Form 4797 as ordinary income in the year of sale. If the amount of your gain equals or is less than the recapture income, you do not have an installment sale. Any gain that is more than the recapture income can be reported on the installment method. For more information on the section 179 deduction, see Publication 534, *Depreciation.* See Publication 544 for more information on depreciation recapture.

To figure your gross profit on the installment sale, add the selling expenses paid on the sale, and the depreciation recapture income reported in the year of sale to your adjusted basis. Then subtract the adjusted basis, as increased, from the selling price to determine your gross profit on the sale.

Installment Sales to Related Persons

Two special rules apply to installment sales between related persons. Test your sale against rule 1 first. If rule 1 does not apply, test your sale against rule 2.

For more information on these kinds of sales, see section 453 of the Internal Revenue Code.

Rule 1: Sale of Depreciable Property

If you sell depreciable property to certain related persons, you may not report the sale using the installment method. Instead, all payments to be received are considered to be received in the year of sale. Depreciable property for this rule is any property that can be depreciated by the person or entity to whom you transfer it.

Payments to be received include the total amount of all payments which are not contingent and the fair market value of any payment that is contingent as to amount.

For any payments which are contingent as to amount but for which the fair market value is not reasonably ascertainable, the basis is recovered ratably and the purchaser may not increase the basis of any property acquired in the sale by any amount before the time the seller includes the amount in income.

Exceptions to rule 1. Rule 1 will not apply to your sale if no significant tax deferral benefits will be derived from the sale or you can show, to the satisfaction of the Internal Revenue Service, that avoidance of federal income taxes was not one of the principal purposes of your sale.

Rule 2: Sale and Resale

There is, generally, a special rule if you make a first disposition (sale or exchange) of property under the installment method to a related person who then makes a second disposition (sale, exchange, gift, or cancellation of installment note):

Before making all payments on the first disposition, and

Within 2 years of the first disposition.

Under this rule, you treat part or all of the amount the related person realizes (or the fair market value if disposed property is not sold or exchanged) from the second disposition as if you received it from the first disposition at the time of the second disposition.

Example 1. In 1989 Harvey Green sold farmland to his son Bob for $500,000, which was to be paid in five equal payments over 5 years, plus adequate stated interest on the balance due. Harvey's installment sale basis for the farmland was $250,000 and the property was not subject to any outstanding liens or mortgages. His gross profit percentage is 50% (his gross profit of $250,000 divided by the contract price of $500,000). Harvey received $100,000 in 1989 and included in his income for that year $50,000 ($100,000 × 0.50). Bob made no improvements to the property and in 1990 sold it to Alfalfa Inc. for $600,000. This is the amount realized from the second disposition. Harvey figures his installment sale income for 1990 as follows:

Amount realized on second disposition or contract price on first disposition, whichever is less	$500,000
Minus: Sum of payments from Bob in 1989 and 1990	200,000
Amount treated as payment because of second disposition	$300,000
Add: Payment from Bob in 1990	100,000
Total payments received and treated as received for 1990	$400,000
Multiply by gross profit percentage	.50
Installment sale income for 1990	$200,000

Harvey will not include in his income from installment sales any principal payments he receives on the installment obligation for 1991, 1992, and 1993 because he has already reported the entire amount of the payments from the first disposition of $500,000 ($100,000 in 1989 and $400,000 in 1990).

Example 2. The facts are the same as in the previous example except that Bob sells the property for only $400,000. The gain for 1990 is figured as follows:

Amount realized on second disposition or contract price on first disposition, whichever is less	$400,000
Minus: Sum of payments from Bob in 1989 and 1990	200,000
Amount treated as payment because of second disposition	$200,000
Add: Payment from Bob in 1990	100,000
Total payments received and treated as received for 1990	$300,000
Multiply by gross profit percentage	.50
Installment sale income for 1990	$150,000

In 1991 Harvey receives a payment of $100,000 from Bob which is not taxed. It is considered to be recovered tax free, because Harvey has already reported the payment and gain in 1990 as the result of the $200,000 which he treated as a payment even though he did not actually receive that payment. Harvey would apply the $100,000 payment in 1991 against this amount. He is also not taxed on the payment he receives in 1992 and he would apply the payment against the $200,000 amount he treated as a payment in 1990. In 1993 Harvey receives the final $100,000 payment. He would figure the amount of gain he must recognize in 1993 from the installment sale as follows:

Sum of payments actually received as of the end of 1993 from the first disposition		$500,000
Minus the sum of:		
Payment from 1989	$100,000	
Payment from 1990	100,000	
Amount treated as payment in 1990	200,000	
Total of amounts on which gain was previously recognized		400,000
Amount of payment on which gain is to be recognized for 1993		$100,000
Multiply by gross profit percentage		.50
Installment sale income for 1993		$ 50,000

Exceptions to rule 2. These rules do not apply to a second disposition, and any later transfer, if you can show, to the satisfaction of the Internal Revenue Service, that neither the first disposition (to the related person) nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, the second disposition will qualify under the nontax avoidance exception in situations when it is involuntary, such as a creditor of the related person foreclosing on the property or the related person declaring bankruptcy.

The nontax avoidance exception will also apply to a second disposition that is also an installment sale if the terms of payment under the installment resale are substantially equal to or longer than those for the first installment sale. However, the exception would not apply if the resale terms would permit significant deferral of recognition of gain from the first sale, for example, if amounts from the resale are being collected sooner.

In addition, the sale or exchange of stock to the issuing corporation is not treated as a first disposition. An involuntary conversion is not treated as a second disposition if the first disposition occurred before the threat of the conversion. A transfer after the death of the person making the first disposition or the related person's death, whichever is earlier, is not treated as a second disposition.

Like-Kind Exchanges

If you trade your property for other property of the same kind, you can often postpone reporting part of your gain. These trades are known as "like-kind exchanges." The property you receive in a like-kind exchange is treated as if it were a continuation of the property you give up.

In a like-kind exchange, you do not have to report any part of your gain that comes from the like-kind property you receive. But if you also receive money or other property, you must report as income the part of your gain that comes from these sources.

Installment payments. If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply:

1) The contract price does not include the fair market value of the like-kind property you receive in the trade.
2) The gross profit is reduced by any gain on the trade that can be postponed.
3) Like-kind property received in the trade is not considered a payment on the installment obligation.

Example. In 1990 George Brown trades personal property with an installment sale basis of $400,000 for like-kind property having a fair market value of $200,000. He also receives an installment note for $800,000 in the trade. Under the terms of the note, he is to receive $100,000 (plus interest) in 1991 and the balance of $700,000 (plus interest) in 1992.

George's gross profit is $600,000 (selling price of $1,000,000 minus $400,000 installment sale basis), and the contract price is $800,000 ($1,000,000 minus the fair market value of the like-kind property received, $200,000). The gross profit percentage is 75% ($600,000 divided by $800,000). George reports no gain in 1990 because the like-kind property he receives is not treated as a payment for the purpose of figuring gain. He reports $75,000 gain for 1991 (75% of $100,000) and $525,000 gain for 1992 (75% of $700,000).

For more information on like-kind exchanges, see *Like-Kind Exchanges* in Publication 544.

Contingent Sales

For installment sales, a contingent sale is a sale for which the total selling price cannot be determined by the end of the tax year in which the sale takes place.

If the selling price cannot be determined by the end of the tax year, the contract price and the gross profit percentage also cannot be determined (using the same rules that apply to an installment sale that has a fixed selling price). This happens, for example, if you sell your business and the selling price includes a percentage of its profits in future years.

For rules permitting use of the installment method to report a contingent sale and for contingent sales with unstated interest, see the regulations under section 453 of the Internal Revenue Code.

Single Sale of Several Assets

If you sell two or more assets in a single sale to one buyer and there is more than one class of asset, you must allocate all payments among the

different classes of assets in proportion to their respective selling prices.

The arm's-length allocation of the selling price and of the payments received in the year of sale will be acceptable if substantiated by all the facts and circumstances. However, an allocation that is not based on the respective selling prices of the assets sold is not acceptable.

If any asset is encumbered by debts that are assumed by the buyer, or the asset is taken subject to a debt and an arm's-length allocation of the down payment or other payments to be received was not made, the down payment and the payments received from installment obligations should be allocated on the basis of the proportionate net fair market values of the assets. The ***net fair market value*** of any asset is its fair market value reduced by any debt the buyer assumes or any debt to which the asset is subject.

A sale of separate and unrelated assets of the same type under a single contract is reported as one transaction for the installment method. However, if an asset is sold at a loss, the disposition of that asset may not be reported on the installment method but must be reported separately. The remaining assets sold at a gain are reported together.

Example. You sold three separate and unrelated parcels of real property, A, B, and C, under a single contract calling for a total selling price of $130,000. The total selling price of $130,000 consisted of a cash payment of $20,000, the buyer's assumption of a $30,000 mortgage on parcel B, and an installment obligation of $80,000 payable in eight installments, plus interest at 12% a year.

Your installment sale basis for each parcel was $15,000. Thus, your net gain was $85,000 ($130,000 minus $45,000). You report the gain on the installment method.

The sales contract did not allocate the selling price or the cash payment received in the year of sale among the individual parcels. The fair market values of parcel A, B, and C were $60,000, $60,000, and $10,000, respectively. Since the installment sale basis for parcel C was more than its fair market value, it was sold at a loss and it must be treated separately.

You must allocate the total selling price and the amounts received in the year of sale between parcel C, sold at a loss, and the remaining parcels.

The total selling price of $130,000 is allocated $120,000 for parcels A and B together and $10,000 for parcel C. The cash payment of $20,000 received in the year of sale and the note receivable should be allocated on the basis of the proportionate net fair market value. The allocation is as follows:

Net fair market value	Parcels A and B	Parcel C
Fair market value	$120,000	$10,000
Minus: Mortgage assumed	30,000	-0-
Net fair market value	$ 90,000	$10,000
Proportionate net fair market value		
Percentage of total	90%	10%
Payments in year of sale		
$20,000 × 90% =	$ 18,000	
$20,000 × 10% =		$ 2,000
Excess of mortgage on parcel B over its installment sale basis	15,000	
Allocation of payments received in year of sale	$ 33,000	$ 2,000

The sale of parcel C may not be reported on the installment method because the sale results in a loss. This loss of $5,000 ($10,000 selling price minus $15,000 installment sale basis) is reported in the year of sale. However, if parcel C was held for personal use, the loss is not deductible.

The installment obligation of $80,000 is allocated to the property sold based on the proportionate net fair market value. Ninety percent of each payment received is from parcels A and B, and 10% of each payment is a return of capital from parcel C.

Installment Sale of a Business

The installment sale of an entire business, operated as a sole proprietorship, for one overall price under a single contract is not the sale of a single asset. The sale generally includes the sale of real and personal property that can be reported on the installment method, and inventory items that are not reported on the installment method. The sale of depreciable property cannot be reported on the installment method to the extent the gain is reported in the year of sale because it is depreciation recapture income. Assets sold at a loss are not reported on the installment method. The selling price must be broken down into separate amounts for each class of asset.

The tax treatment of the gain or loss on the sale of each class of asset is determined by its classification as capital asset, property used in the business, or inventory and, for capital assets and property used in the business, by the length of time held. Therefore, separate computations may be required to determine the gain or loss for each asset sold. For more information, see *Sale of a Business*, in Publication 544.

Goodwill. Goodwill is a capital asset that may or may not exist within a business. If it does exist, then when the business is sold, the seller can receive capital gain treatment on the part of the sales price that is for goodwill.

Goodwill is also used to represent ***going concern value*** and includes every positive advantage that a firm gets in doing its business. It is the total of all those indefinable qualities that bring customers to a business, such as the right to have the business at a particular location under a trade name or trademark, any special knowledge or know-how, the number and quality of customers, or any other similar elements of value in the business as a going concern.

Except for assets exchanged under the like-kind exchange rules, both the buyer and seller of a business must use the residual method (explained later) to allocate the sales price to the various business assets transferred. This method determines the gain or loss from the transfer of each asset and how much of the sales price is for goodwill.

The residual method must be used for any transfer of a group of assets that continues a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business, or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid. A group of assets constitutes a trade or business if goodwill could, under any circumstances, attach to the assets.

Residual method. The residual method provides for the sales price to be reduced first by the amount of cash, demand deposits, and similar accounts transferred by the seller. The amount of sales price remaining after this reduction must be allocated among the business' various assets in a specified order, and then the remainder of the sales price must be allocated to goodwill.

The allocation must be made among the following assets in proportion to (but not in excess of) their fair market value on the purchase date in the order specified.

1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency.
2) All other assets, both tangible and intangible, except goodwill.

After making this allocation, the remainder of the sales price is allocated to goodwill.

How to report. To report the information on the allocation you must use Form 8594, *Asset Acquisition Statement*, or a statement that includes:

1) Amount of sale (purchase),
2) Allocation of the sales (purchase) price to goodwill or going concern value, and
3) Any information concerning subsequent increases or decreases to the sales (purchase) price.

Inventory. If inventory items are included in an installment sale, you may have an agreement with the buyer concerning which payments are for inventory and which are for the other assets being sold. If you do not have an agreement, a part of each payment must be allocated to inventory, just as a part of each payment is allocated to every other asset that is sold.

However, gain on the sale of inventory items cannot be reported on the installment method. All of your gain on their sale must be reported as income in the year of sale, even if you are to be paid in later years.

The amount you receive (or will receive) on the sale of inventory items is reported as ordinary business income on Schedule C (Form 1040). Your basis in the items is used to figure the cost of goods sold, and the part of the selling expenses allocated to inventory is deducted as an ordinary business expense.

Notes received. If inventory items are included in an installment sale, and if the fair market value of the buyer's notes is less than their face value at the time you receive them, you figure gain on the inventory items on the fair market value of the notes rather than on their face value. This is true even though you report gains on other items in the sale on the installment method and figure those gains on the basis of the face value of the notes. The part of the note payments you receive for assets included in inventory is treated the same as the note payments when you elect out. See *Fair market value* under *Electing Out*, earlier.

Example. On January 4, 1990, you sold the machine shop you had operated since 1981. You received a $100,000 down payment and the buyer's note for $120,000. The note payments are $15,000 each, plus 12% interest, due every July 1 and January 1, beginning in 1991. The total selling price is $220,000. Your selling expenses are $11,000. The selling expenses are divided among all the assets sold, including inventory.

Your selling expense for each asset is 5% of the asset's selling price ($11,000 selling expense divided by $220,000 total selling price).

The fair market value (FMV), adjusted basis, and depreciation claimed on each asset sold are as follows:

Asset	FMV	Depreciation Claimed	Adjusted Basis
Inventory	$10,000	—	$ 8,000
Land	42,000	—	15,000
Building	48,000	$ 9,000	36,000
Machine A	71,000	27,200	63,800
Truck	6,500	18,624	5,376
Machine B	24,000	12,960	22,040

The total amount of the selling price allocated to these assets is $201,500, based on their FMV.

The remaining amount, $18,500, is allocated to goodwill.

The assets included in the sale, their selling prices based on their fair market values, the selling expense allocated to each asset, the adjusted basis and the gain for each asset are shown in the following chart.

	Selling price	Selling expense	Adjusted basis	Gain
Inventory	$ 10,000	$ 500	$ 8,000	$ 1,500
Land	42,000	2,100	15,000	24,900
Building	48,000	2,400	36,000	9,600
Machine A	71,000	3,550	63,800	3,650
Truck	8,500	325	5,376	799
Machine B	24,000	1,200	22,040	760
Goodwill	18,500	925	0	17,575
	$220,000	$11,000	$150,216	$58,784

The building which was acquired in 1981, the year the business began, is section 1250 property. There is no depreciation recapture income because the building was depreciated using the straight line method.

All the gain on the truck, machine A, and, machine B is depreciation recapture income.

The total depreciation recapture income reported in Part II of Form 4797 is $5,209. This is made up of $3,650 on machine A, $799 on the truck, and $760 on machine B. The gain on these items is reported in full. Therefore, they are not included in the installment sale computation.

Of the $220,000 total selling price, $10,000 is for inventory assets that cannot be reported on the installment method. The selling prices of the truck and machines are also removed from the total selling price because the gain on these items is reported in the year of sale. The selling price and contract price for the installment sale is $106,500.

The assets included in the installment sale, their selling price, and their installment sale basis are shown in the following chart.

	Selling price	Installment sale basis	Gross profit
Land	$ 42,000	$ 17,100	$24,900
Building	48,000	38,400	9,600
Goodwill	18,500	925	17,575
Total	$106,500	$ 56,425	$52,075

The ***gross profit percentage*** (gross profit divided by the contract price) for the assets is figured as follows:

	Percentage
Land—$24,900 divided by $106,500	23.38
Building—$9,600 divided by $106,500	9.01
Goodwill—$17,575 divided by $106,500	16.5
Total	48.9

Income for 1990. You must report the ordinary income amount in the year of sale. The amount that you receive in the year of sale ($10,000 down payment) should be allocated to the items that cannot be reported on the installment method.

You must allocate $10,000 to the inventory. This amount is reported on Schedule C (Form 1040) as ordinary business income. Your basis ($8,000) is used to figure your cost of goods sold, and the selling expense ($500) is deducted as an ordinary business expense.

The remaining part of the down payment ($90,000) is allocated to the sale of the items that resulted in the depreciation recapture income. The selling price of these assets is $101,500. Therefore, the total amount ($90,000) is allocated to these items. You must include in your income for 1990 the total amount of the depreciation recapture income even though you did not receive the full selling price in that year. In addition, $11,500 of the amount received in 1991 will be allocated to these items. The remainder of the $30,000 received in 1991 is reported on the installment sale method.

Installment income for 1991. Your installment income for each asset is the gross profit percentage for that asset times the total amount received in 1991 on the installment sale.

The total amount received in 1991 on the installment sale is $18,500 ($30,000 - $11,500).

	Income
Land—22.95% of $18,500	$ 4,246
Building—8.85% of $18,500	1,637
Goodwill—16.2% of $18,500	2,997
Total installment income for 1991	$ 8,880

Installment income after 1991. You figure installment income for years after 1991 by applying the same gross profit percentages to the total payments payments you receive on the buyer's note during the year.

Installment reporting of sale of partnership interest. A partner who sells a partnership interest at a gain may be able to report the sale on the installment method. The sale of a partnership interest is treated as the sale of a single capital asset. However, you must make an allocation if the partnership's assets included unrealized receivables and substantially appreciated inventory items. (The term "unrealized receivables" includes depreciation recapture income, discussed earlier.)

The gain allocated to the recapture income and the substantially appreciated inventory cannot be reported under the installment method. The gain allocated to the other assets can be reported under the installment method.

For more information on unrealized receivables and substantially appreciated inventory, see Publication 541, *Tax Information on Partnerships*.

Unstated Interest

An installment sale generally provides that each deferred payment on the sale will include interest or that there will be an interest payment in addition to the principal payment. Interest that is provided for in the contract is referred to as ***stated interest.***

If an installment sale with some or all of the payments due more than one year after the date of sale does not provide for interest, a part of each payment due more than 6 months after the date of sale will be treated as interest. The amount treated as interest is referred to as ***unstated interest*** or ***imputed interest.***

When the stated interest in the contract is under a rate of interest specified by law (generally, 9% compounded semiannually), the unstated interest is the difference between the specified rate of interest and the stated interest.

Effects of unstated interest. Imputed interest affects the selling price and the contract price. It also affects the amount of gain on the sale, whether you use the installment method or elect out.

Selling price and contract price. If you use the installment method for reporting your gain on the sale, both the selling price and the contract price must be reduced by any imputed interest. All the other rules relating to installment sales apply as they would if there were no imputed interest.

If you elect out of the installment method. If you do not report your sale using the installment method, you must report your entire gain in the year of sale. However, if you find that the payments you are to receive will include imputed interest, you must reduce the selling price by the total amount of imputed interest before you can determine the gain or loss.

The amount of interest you must report is the sum of the imputed interest plus any interest specified under the contract.

Rules for Imputing Interest

If the unstated interest rules apply, both the buyer and the seller must treat a part of the installment sale price as interest. The unstated interest rules require you to treat part of each payment as interest, even though it is not called interest in your agreement with the buyer. The amount of unstated interest will reduce the stated selling price of the property and increase the seller's interest income and the buyer's interest expense.

The imputed interest rule applies even if you elect out of the installment method or have a loss on the sale. It applies even if you can postpone or otherwise not recognize all or part of your gain or loss in the year that the sale takes place.

A debt instrument must provide for adequate stated interest. If a debt instrument does not provide for adequate stated interest, interest is imputed on the debt. Generally, a debt instrument provides for adequate stated interest if it calls for interest at a rate no lower than the test rate of interest applicable to the debt instrument.

Test rate of interest. For sales or exchanges of property (other than new section 38 property, which includes most tangible personal property) involving seller financing of $2,933,200 or less, the test rate of interest is the lower of the applicable federal rate of interest or 9%, compounded semiannually. If the seller financing is in excess of $2,933,200, and for all sales or exchanges of new section 38 property, the test rate of interest is 100% of the applicable federal rate.

Section 1274 of the Internal Revenue Code applies to any debt instrument issued for the sale or exchange of property if some or all of the payments due under the debt instrument are due more than 6 months after the date of the sale or exchange. Section 483 of the Code applies to sales or exchanges of property that are not covered by the provisions of section 1274.

Section 1274 is discussed later.

Section 483 rules. For a sale or exchange of property, the section 483 rules apply to any payment that constitutes all or part of the selling price and that is due more than 6 months after the date of the sale or exchange under a contract under which:

1) Some or all of the payments are due more than 1 year after the date of the sale or exchange, and
2) There is total unstated interest (or inadequate stated interest).

Total unstated interest. Total unstated interest is an amount equal to the excess of:

1) The sum of the payments due under the contract, over
2) The sum of the present values of the payments and the present values of any interest payments due under the contract.

Transactions to which section 483 rules apply. The section 483 rules apply to debt instruments arising from sales or exchanges of:

1) A farm for $1,000,000 or less by an individual, estate, testamentary trust, small business corporation (defined in section 1244(c)(3)) of the Internal Revenue Code), or a domestic partnership that meets requirements similar to those of section 1244(c)(3),
2) A principal residence by the owner,
3) Property with total payments (principal and interest) of $250,000 or less, or

4) Qualified sale of land between related parties.

In addition, the section 483 rules apply to a ***cash method debt instrument.*** A cash method debt instrument is any debt instrument given as consideration for the sale or exchange of property (other than new section 38 property as defined in section 48(b)) with a stated principal amount of $2,095,100 or less and:

1) The lender (holder) does not use an accrual method of accounting and is not a dealer in the type of property sold or exchanged,
2) Both the borrower (issuer) and the lender jointly elect to account for the interest under the debt instrument on the cash method of accounting, and
3) Section 1274 of the Code would have applied except for the election in (2) above.

Sale of a farm. The section 483 rules apply to the sale of a farm if the selling price cannot exceed $1,000,000. If the selling price can exceed $1,000,000, the section 1274 rules (discussed later) apply. For purposes of determining the selling price, all sales and exchanges that are part of the same transaction (or a series of transactions) are treated as one sale or exchange.

Sales with total payments of $250,000 or less. If:

1) The aggregate amount of the payments (interest and principal) due under the debt instrument and under all other debt instruments received as consideration for the sale or exchange, and
2) The aggregate amount of any other consideration to be received for the sale or exchange,

cannot exceed $250,000, the section 483 rules apply. The section 1274 rules apply if the amount can exceed $250,000.

Any consideration (other than a debt instrument) is taken into account at its fair market value. All sales and exchanges that are part of the same transaction (or series of related transactions) are treated as one sale or exchange.

Land sales between related parties. The section 483 rules apply to land sales between related parties to the extent that the sales price when added to the aggregate sales price of prior land sales between the individuals during the calendar year does not exceed $500,000. The section 1274 rules, if otherwise applicable, apply to a sale of land to the extent the sales price is in excess of $500,000. In addition, section 1274 applies to a sale of land if any party to the sale is a nonresident alien individual.

Related parties include an individual and the members of that individual's family. The members of an individual's family include the individual's spouse, brother and sister (whether by whole or half blood), ancestors and lineal descendants.

Exceptions to section 483 rules. The unstated interest rules do not apply to the following types of transactions.

Sales price of $3,000 or less. If it can be determined at the time of the sale or exchange of the property that the selling price will not exceed $3,000, the unstated interest rules do not apply to the sale or exchange.

Carrying charges. The buyer of personal property need not figure unstated interest if any part of the payments includes separately stated carrying charges deductible in part as interest. If the buyer makes an installment purchase under a plan in which carrying charges are separately stated but the interest cannot be determined, the buyer can deduct, as interest, the lesser of:

1) An amount equal to 6% of the average unpaid balance under the contract during the year, or
2) The part of the total carrying charges allocable to the year.

Additional exceptions. See the discussion of the exceptions that apply to both sections 483 and 1274, later.

Section 1274 rules. The section 1274 rules apply to any debt instrument given in consideration for the sale or exchange of property if:

1) The stated redemption price at maturity for the debt instrument exceeds:
   a) The stated principal amount when there is adequate stated interest, or
   b) The imputed principal amount in all other cases, and
2) Some or all of the payments under the debt instrument are due more than 6 months after the date of the sale or exchange.

There is adequate stated interest under section 1274 if the stated principal amount for a debt instrument is less than or equal to the imputed principal amount. The imputed principal amount of any debt instrument is equal to the sum of the present values of all payments under the debt instrument.

Imputed principal. In transactions to which these rules apply the issue price of the debt instrument has to be determined. Where there is adequate stated interest, the issue price is the stated principal amount. If the debt instrument does not provide for adequate stated interest, the issue price of the instrument is the imputed principal amount of the debt instrument. The issue price of a debt instrument is generally used to determine the sale price (in whole or in part) of any property acquired for the debt instrument.

Exceptions to the imputed principal rules. The imputed principal rules do not apply to any of the debt instruments involved in transactions listed above under *Transactions to which section 483 applies.* (Also see *Exceptions to section 483 and 1274,* later.)

Assumptions. If an existing debt instrument is assumed, or property is acquired subject to a debt instrument, in determining if the imputed interest rules apply to the debt instrument the assumption (or acquisition) is not taken into account unless the terms or conditions of the debt instrument are modified or the nature of the transaction is changed.

Exceptions to sections 483 and 1274. The imputed interest rules do not apply in the following circumstances:

Publicly traded debt instruments or property. Transactions involving publicly traded debt instruments or any debt instrument issued in consideration for the sale or exchange of publicly traded property are not subject to the imputed interest rules. A publicly traded instrument is one that is traded on an established securities market.

Treatment of obligors. An obligor or borrower (issuer) under a debt instrument given in consideration for the sale or exchange of property that is personal use property in the hands of the issuer. Personal use property is any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an investment activity.

Patents. When all substantial rights to a patent, or an undivided interest in property that includes a part of all substantial rights to a patent, are sold or exchanged, the seller need not figure unstated interest or imputed principal on any amount that is contingent upon the productivity, use, or disposition of the property transferred. This rule applies only if the seller is the inventor or a buyer who purchased the patent or rights to the patent from the inventor before the invention was reduced to practice.

Annuities. Payments that depend in whole or in part on the life expectancy of any individual do not require the computation of unstated interest or imputed principal.

Additional information. For information on the computation of imputed interest and other special rules, see sections 483 and 1274 of the Code and the regulations thereunder.

Dispositions of Installment Obligations

A disposition generally includes a sale, exchange, cancellation, bequest, distribution, or transmission of an installment obligation. An ***installment obligation*** is the buyer's note, deed of trust or other evidence that the buyer will make future payments to you.

If you dispose of an installment obligation, you will usually have a gain or loss to report. The gain or loss is considered to be gain or loss on the sale of the property for which you received the installment obligation. If the original installment sale of the property produced ordinary income, the disposition of the obligation will result in ordinary income or loss. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain or loss.

Use the following rules to figure your gain or loss from the disposition of an installment obligation.

If you ***sell or exchange the obligation,*** or if you accept less than face value in satisfaction of the obligation, the gain or loss is the difference between your basis in the obligation and the amount you realize.

If you ***dispose of the obligation in any other way,*** the gain or loss is the difference between your basis in the obligation and its fair market value at the time of the disposition. This rule applies, for example, when you give the installment obligation to someone else or cancel the buyer's debt to you.

Some situations in which these rules may or may not apply are discussed in the following paragraphs:

Transfers between spouses or former spouses. No gain or loss is recognized on the transfer of an installment obligation between a husband and wife or a former husband and wife if incident to a divorce. A transfer is incident to a divorce if it occurs within one year after the date on which the marriage ends, or is related to the end of the marriage. The same tax treatment for the transferred obligation applies to the spouse or former spouse receiving it as would have applied to the transferor spouse or former spouse. The basis of the obligation to the transferee spouse (or former spouse) is the adjusted basis of the transferor spouse.

The nonrecognition rule does not apply if the spouse or former spouse receiving the obligation is a nonresident alien.

Gifts. A gift of an installment obligation is a disposition. The gain or loss is the difference between your basis in the obligation and its fair market value at the time you make the gift.

For gifts between spouses or former spouses, see *Transfers between spouses or former spouses,* earlier.

Cancellation. If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its fair

market value at the time you cancel it. If you and the buyer are related persons, the fair market value of the obligation is considered to be no less than its full face value.

Forgiving part of the buyer's debt. If you accept part payment on the balance of the buyer's installment debt to you and forgive the rest of the debt, you treat the settlement as a disposition of the installment obligation. The gain or loss is the difference between your basis in the obligation and the amount you realize on the settlement.

If you reduce the selling price but do not cancel the rest of the buyer's debt to you, it is not considered a disposition of the installment obligation. You must refigure the gross profit percentage and apply it to payments you receive after the reduction.

Assumptions. If the buyer of your property sells it to someone else and you agree to let the new buyer assume the original buyer's installment obligation, you have not disposed of the installment obligation. It is not a disposition even if the new buyer must pay you a higher rate of interest than the original buyer.

Installment obligations transferred because of death. The transfer of an installment obligation as a result of the death of the seller or other holder of the obligation is not a disposition. Unreported gains from the installment obligations are treated as items of gross income in respect of a decedent. This means that whoever receives the installment obligation as a result of the holder's death is taxed on the installment payments in the same way as the seller or other holder would have been if the holder had lived to receive the payments.

However, if an installment obligation is canceled, becomes unenforceable, or transferred to the buyer, because of the death of the holder of the obligation, it is a disposition. The estate must figure its gain or loss on the disposition. If the holder and the buyer were related persons, the fair market value of the installment obligation is considered to be no less than its full face value.

Basis. Your basis in an installment obligation depends on the amount that has not been paid on the obligation (the unpaid balance) and your gross profit percentage.

The amount of profit on the installment sale payments that you have not already received from the buyer is determined by multiplying the unpaid balance by the gross profit percentage.

The remainder of the unpaid balance is your basis in the obligation. It represents the part of your adjusted basis in the property you sold that you have not already recovered in payments from the buyer.

Example. Several years ago you sold some property on the installment method. The buyer still owes you $10,000 of the sales price. This is the unpaid balance on the buyer's installment obligation to you. Because your gross profit percentage is 60%, $6,000 (60% of $10,000) is the profit still due you on the obligation. The rest of the unpaid balance, $4,000, is your basis in the obligation.

Repossessions

If, after making an installment sale, you repossess your property from the buyer, you have to figure:

1) Your gain (or loss) on the repossession, and
2) Your basis in the repossessed property.

The rules for doing this depend on the kind of property you repossess. The rules for repossessions of personal property differ from those for real property. In addition, special rules may apply if you repossess property that was your principal residence before the sale.

The repossession rules apply whether or not title to the property was ever transferred to the buyer. It also does not matter how you repossess the property—whether you foreclose or the buyer voluntarily surrenders the property to you. However, it is not a repossession if the buyer puts the property up for sale and you repurchase it.

For the repossession rules to apply, the repossession must at least partially discharge (satisfy) the buyer's installment obligation to you. The discharged obligation must be one that is secured by the property you repossess. This requirement is met if the property is auctioned off after you foreclose and you apply the installment obligation to your bid price at the auction.

Reporting the repossession. You report gain or loss from a repossession on the same form that you used to report the original sale. If you reported the sale on Form 4797, use Form 4797 to report the gain or loss on the repossession.

Personal Property

If you repossess personal property, you may have a gain or a loss on the repossession. In some cases, you may also end up with a bad debt.

To figure your gain or loss, subtract your basis in the installment obligation and any expenses you have in connection with the repossession from the fair market value of the property. If you receive anything from the buyer in addition to the repossessed property, it should be added to the property's fair market value before making this subtraction.

The way you figure your basis in the installment obligation depends on whether or not you reported the original sale using the installment method. The method you used to report the original sale also affects the character of your gain or loss on the repossession.

For sales not reported on the installment method:

Basis. Your basis in the installment obligation is figured on its full face value or its fair market value at the time of the original sale, whichever you used to figure your gain or loss in the year of sale. From this amount, subtract all the payments of principal you have received on the obligation. The result is your basis in the installment obligation. If only a part of the obligation is discharged by the repossession, figure your basis only in that part.

Gain or loss. To your basis in the obligation, add any expenses you have in connection with the repossession. If the fair market value of the property you repossess is more than this total, you have a gain. Because the gain is gain on the installment obligation, it is all ordinary income, not capital gain. If the fair market value of the repossessed property is less than the total of basis plus repossession expenses, you have a loss. Because the loss is a loss on the installment obligation, it is a bad debt loss. How you deduct the loss depends on whether you sold business or nonbusiness property in the original sale. See Publication 550, *Investment Income and Expenses*, for more information on nonbusiness bad debts and Publication 535, *Business Expenses*, for information on business bad debts.

For sales reported on the installment method:

Basis. Your basis in the installment obligation is its face value at time of repossession minus the unreported profit (the amount of gain you would have reported as income in the future if you had held the obligation to maturity). If only a part of the installment obligation is discharged by the repossession, figure your basis only in that part.

Gain or loss. Your gain or loss on the repossession is the same character as your gain on the original sale. If you had a long-term capital gain on the original sale, you will have a long-term capital gain or loss on the repossession. If your original gain was ordinary, your gain or loss on the repossession will also be ordinary.

Worksheet. The following worksheet can be used to determine the taxable gain or loss on a repossession of personal property reported on the installment method.

1) Fair market value of property repossessed		
2) Selling price		
3) Minus: Payments made before repossession		
4) Face value of obligation at time of repossession		
5) Minus: Unrealized profit (amount on line 4 times gross profit percentage)		
6) Basis of obligation (amount on line 4 minus amount on line 5)		
7) Gain or loss on repossession (amount on line 1 minus amount on line 6)		
8) Minus: Repossession costs		
9) Taxable gain or loss on repossession		

Example. You sold your piano for $1,500 in December 1989 for $300 down and $100 a month (plus interest). The payments began in January 1990. Your gross profit percentage is 40%. You reported the sale on the installment method on your 1989 income tax return. After the third monthly payment, the buyer defaults on the contract and you are forced to foreclose on the piano. The fair market value of the piano on the date of repossession is $1,400. The legal costs of foreclosure and the expense of moving the piano back to your home total $100. You figure your gain on the repossession as follows:

1) Fair market value of property repossessed		$1,400
2) Selling price	$1,500	
3) Minus: Payments made before repossession	600	
4) Face value of obligation at time of repossession	$900	
5) Minus: Unrealized profit (amount on line 4 times gross profit percentage)	360	
6) Basis of obligation (amount on line 4 minus amount on line 5)		540
7) Gain or loss on repossession (amount on line 1 minus amount on line 6)		$860
8) Minus: Repossession costs		100
9) Taxable gain or loss on repossession		$760

Basis. Your basis in repossessed personal property is its fair market value at the time of the repossession.

Fair market value. The fair market value of repossessed property is a question of fact to be established in each case. If you bid for the property at a lawful public auction or judicial sale, its fair market value is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary.

Bad debt. If the installment obligation is not fully satisfied by the repossession, the same circumstances that led you to repossess your property may mean that you cannot collect on the rest of the buyer's debt to you. If you cannot, you may be able to take a bad debt deduction for that part of the installment obligation. This rule applies to sales not reported under the installment method. See Publication 550 for more information

on nonbusiness bad debts and Publication 535 for information on business bad debts.

Real Property

The rules for repossessions of real property allow you to keep essentially the same adjusted basis in the repossessed property as you had before the original sale. You will be able to recover this entire adjusted basis when you resell the property. This, in effect, cancels out the tax treatment you had on the original sale, and puts you in the same tax position you were in before that sale.

Therefore, the full amount of any payments you have already received from the buyer on the original sale must be regarded as income to you. You must report, as gain on the repossession, any part of those payments that you did not yet include in your income, that is, the part that had been regarded as a return of your adjusted basis rather than as gross profit. However, the total gain you must report is limited as discussed later.

Conditions. The rules given below are ***mandatory.*** You must use these rules to figure your basis in the repossessed real property and your gain on the repossession. The rules apply whether or not you reported the sale on the installment method. However, these rules apply only if all of the following conditions are met:

First, the repossession must be to protect your security rights in the property.

Second, the installment obligation that is satisfied by the repossession must have been received in the original sale.

Third, you cannot pay any additional consideration to the buyer to get your property back, unless either:

a) The reacquisition and payment of the additional consideration were provided for in the original contract of sale, or

b) The buyer has defaulted, or default is imminent.

"Additional consideration" includes money and other property you pay or transfer to the buyer. For example, additional consideration is present if you reacquire the property subject to an indebtedness that arose after the original sale.

Conditions not met. If any of these three conditions are not met, use the rules discussed under *Personal Property,* earlier, as if the property you repossess is personal rather than real property. Do not use the rules for real property.

Figuring gain on repossession. Your gain on repossession is the difference between:

The total payments you have received, or are considered to have received, on the sale, and

The total amount of gain you have already reported as income.

See the earlier discussion under *Payments* for the definition of what is considered a payment on the sale.

Limit on taxable gain. There is a limit on the amount of gain that is taxable. Taxable gain is limited to an amount equal to your gross profit on the original sale, minus the sum of:

1) The gain on the sale you reported as income before the repossession, and
2) Your repossession costs.

This method of figuring taxable gain, in essence, treats all of the payments you received on the sale as income, but limits your total taxable gain to the gross profit you originally expected on the sale.

Repossession costs. Your repossession costs include money or property you pay for the reacquisition of the real property. This includes amounts paid to the buyer of the property as well as amounts paid to others for such items as court costs and legal fees. Repossession costs do not include the fair market value of the buyer's obligations to you that are secured by the real property.

Worksheet. The following worksheet can be used to determine the taxable gain on a repossession of real property reported on the installment method.

1) Payments received before repossession		
2) Minus: Gain reported (amount on line 1 times gross profit percentage)		
3) Gain on repossession		
4) Gross profit on sale		
5) Gain reported (amount on line 2)		
6) Plus: Repossession costs		
7) Subtract amount on line 6 from amount on line 4		
8) Taxable gain (lesser of amount on line 3 or 7)		

Example. You sold a tract of land in January 1988 for $25,000. You accepted from the buyer a $5,000 down payment, plus a $20,000 (9.5%) mortgage, secured by the property and payable at the rate of $4,000 annually plus interest. The payments began on January 1, 1989. Your adjusted basis in the property was $19,000 and you reported the transaction as an installment sale. Your selling expenses were $1,000. You figured your gross profit as follows:

Selling price		$25,000
Minus:		
Adjusted basis	$19,000	
Selling expenses	1,000	20,000
Gross profit		$ 5,000

For this sale, the contract price equals the selling price. Therefore, the gross profit percentage is 20%. This is figured by dividing the gross profit of $5,000 by the contract price of $25,000.

In 1988 you included $1,000 in your income (20% of the $5,000 down payment). In 1989 you reported profit of $800 (20% of the $4,000 annual installment). In 1990 the buyer defaulted and you repossessed the property. You spent $500 in legal fees to get your property back. Your gain on the repossession is figured as follows:

Payments received ($5,000 + $4,000)	$9,000
Minus: Gain previously reported as income ($1,000 + $800)	1,800
Gain	$7,200

Not all of this gain is taxable. The limit on taxable gain is figured as follows:

Gross profit on original sale		$5,000
Minus:		
Gain previously reported as income	$1,800	
Repossession costs	500	2,300
Taxable gain on repossession		$2,700

Indefinite selling price. The limit on taxable gain does not apply if the selling price is indefinite and cannot be determined at the time of repossession. For example, a selling price that is stated as a percentage of the profits to be realized from the buyer's development of the property is an indefinite selling price.

Character of gain. The taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale. However, if you did not report the sale on the installment method, the gain is ordinary income.

Basis. Your basis in the repossessed property is determined as of the date of repossession. It is the sum of:

1) Your adjusted basis in the installment obligation,
2) Your repossession costs, and
3) The taxable gain on the repossession.

To figure your adjusted basis on the installment obligation at the time of repossession, subtract any unreported profit (the amount of gain you would have reported as income in the future had you held the obligation to maturity) from its face value at the time of repossession.

Worksheet. The following worksheet can be used to determine the basis of real property repossessed.

1) Face value of obligation at time of repossession (selling price minus payments received)		
2) Minus: Unreported profit (amount on line 1 times gross profit percentage)		
3) Adjusted basis on date of repossession		
4) Plus:		
Taxable gain on repossession		
Repossession costs		
5) Basis of repossessed real property		

Example. Assume the same facts as in the preceding example. The face value of the installment obligation (the $20,000 note) is $16,000 at the time of repossession, because the buyer had made a $4,000 payment. The gross profit percentage on the original sale was 20%. Therefore, $3,200 (20% of the $16,000 still due on the note) is unreported profit. You figure your basis in the repossessed property as follows:

Face value of obligation at time of repossession		$16,000
Minus: Unreported profit		3,200
Adjusted basis on date of repossession		$12,800
Plus: Taxable gain on repossession	$2,700	
Repossession costs	500	3,200
Basis of repossessed real property		$16,000

Holding period for resales. If you resell the property you repossessed, the resale may result in a capital gain or a capital loss. To figure whether it is a long-term or a short-term gain or loss, your holding period includes the period you owned the property before the original sale plus the period after the repossession. It does not include the period the buyer owned the property.

If the buyer made improvements to the reacquired property, the holding period for these improvements begins on the day after the date of repossession.

Bad debt. If you repossess real property under these rules, you cannot take a bad debt deduction for any part of the buyer's installment obligation. This is so even if the obligation is not fully satisfied by the repossession.

If you had already taken a bad debt deduction before the tax year of repossession, you are considered to have recovered the bad debt when you repossess the property. The amount of the bad debt deduction you took in the earlier year must be reported as income in the year of repossession. However, if any part of the earlier deduction did not serve to lower your tax, you do not have to report that part as income. Your adjusted basis in the installment obligation is increased by the amount you report as income.

Repossessing Your Former Home

When you sell your home, you may be permitted to postpone paying tax on part or all of your gain if you acquire a replacement residence within a

specified period of time. You also may be allowed to exclude some or all of your gain from income if you are age 55 or older. See Publication 523, *Tax Information on Selling Your Home*, for information on the postponement of tax and exclusion of gain on these sales.

Special rules apply if, after using one or both of these provisions for your sale, you repossess your former home and sell it once again. Under these rules, you do not have any gain or loss at the time of repossession. Instead, the sale and resale are combined and treated as a single transaction. You then figure your gain on the combined sale-resale, including how much of the gain you can exclude or postpone paying tax on. These special rules apply only if:

1) The resale takes place within one year of the repossession, and
2) At least some of your gain on the original sale was not taxed because you acquired a replacement home or because you were age 55 or older.

If the resale does not take place within one year of the repossession, the general rules for repossessions of real property discussed earlier under *Real Property*, are applicable.

Gain. To figure your gain under the special rule, you must first figure both the amount you realize on the combined sale-resale and your adjusted basis in the home. The difference between these two amounts is your gain on the combined sale-resale. You then figure how much of this gain you can exclude or postpone paying tax on, using the same rules that would apply to any sale.

Amount realized. To figure the amount you realize on the combined sale-resale of your home, add the selling price on the resale to the selling price on the original sale, and subtract:

1) Your selling expenses for both sales,
2) The part of the original installment obligation that remains unpaid at the time of repossession, and
3) Your repossession costs.

Example. You sold your home for $50,000. Two years after the sale, you repossessed your property and resold it within one year for $55,000. When you repossessed, the first buyer owed you $36,000 on the original sale, and you paid $1,000 in connection with the repossession. Your selling expenses were $2,000 originally and $3,000 on the resale.

The amount realized on the combined sale-resale is figured as follows:

Selling price on resale		$ 55,000
Plus: Selling price on original sale		50,000
Total		$105,000
Minus:		
Selling expenses on resale	$ 3,000	
Selling expenses on original sale	$ 2,000	
Amount unpaid on note	36,000	
Repossession costs	1,000	42,000
Amount realized on sale-resale		$ 63,000

Adjusted basis. To figure your adjusted basis for the combined sale-resale, begin with your adjusted basis in the property at the time of the original sale and make any adjustments to the property for the period after repossession. You cannot adjust your basis for the period that the buyer owned the property.

You may have to make two other adjustments:

1) If the buyer became further in debt to you after the original sale, and this debt was also secured by the property you repossessed, add in the amount outstanding on this debt when figuring your adjusted basis. In this way, when you figure gain on the combined sale-resale, you will be able to take into account the full amount that is owed you.
2) If, in an earlier year, you took a bad debt deduction for any of the buyer's obligations that were secured by the property you repossess, you must subtract the amount of the deduction when figuring your adjusted basis. If only part of the deduction served to reduce your tax, you need subtract only that part.

Excluded or deferred gain on resale. If you are age 55 or older and are excluding any part of your gain for that reason, use the gain on the combined sale-resale to see how much gain you can exclude.

If you bought a replacement home and are postponing part of your gain for that reason, you must refigure both:

1) The amount of gain you can postpone, and
2) Your adjusted basis in the replacement home.

From the amount realized on the combined sale-resale, subtract any "fixing-up" expenses you had in connection with either sale. The result is the adjusted selling price for the sale-resale. Compare this amount to (1) the cost of the replacement home and (2) your gain from the combined sale-resale to figure both the amount of gain you can postpone and your adjusted basis in the replacement home.

You are allowed to take into account fixing-up expenses for both the sale and resale. Publication 523 discusses fixing-up expenses.

Reporting taxable gain. If you already reported any gain from the original sale, the amount you reported should be subtracted when reporting your gain from the combined sale-resale. Make any necessary adjustments on your tax return for the year of the resale.

Bad debt. If you repossess your home under these rules, you cannot take a bad debt deduction for the original installment obligation, or for any other obligation that was secured by the property you repossess.

Reporting an Installment Sale

You must use Form 6252, *Installment Sale Income*, anytime you have a sale of property that you report as an installment sale. The form is used to report the sale in the year it takes place, and to report payments received in later years. In addition, if you made the sale to a related person, you may have to file the form each year until the installment debt is paid off, whether you receive a payment during the year or not.

Sales to a related person. If you sell marketable securities to a related person, complete Part III, Form 6252, for each year of the installment agreement, even if you do not receive a payment in that year.

If you sell property other than marketable securities to a related person, complete Part III for the year of sale and the 2 years following the year of sale, even if you do not receive a payment. After this 2-year period, you do not have to fill out Part III.

Later dispositions. If the related person you sold your property to disposes of it, you may have to immediately report the rest of your gain in Part III. See *Rule 2: Sale and Resale* under *Installment Sales to Related Persons*, earlier, for more information.

Several assets. If you sell two or more assets in one installment sale, you may have to report the sale of each asset separately. The same is true if you sell all the assets of your business in one installment sale. See *Single Sale of Several Assets*, and *Installment Sale of a Business*, earlier.

If you do not have too many sales to report separately, you may use a separate Form 6252 for each one. However, if you have to report separately the sales of many assets that you sold together, do not prepare a separate Form 6252 for each one. Instead prepare one Form 6252 and attach a schedule that contains all the information for each asset that is required by Form 6252. You would complete Form 6252 as follows:

1) Answer the questions at the top of the form.
2) In the year of sale, do not complete Part I. Instead write "See attached schedule" in the margin.
3) For Part II, enter the total for all the assets on lines 20, 21, and 22.
4) For Part III, answer all the questions that apply. If none of the exceptions under question H apply, enter the totals on lines 28, 29, and 30 for all the assets that were disposed of.

Payments past due. Do not report payments of principal that you have not yet received, even if they are past due. However, if you use the accrual method of accounting, you have to accrue the payment that is due even though you have not yet received payment.

Special situations. If you are reporting payments from an installment sale as income in respect of a decedent or as a beneficiary of a trust, including a partial interest in such a sale, you may not be able to provide all the information asked for on Form 6252. To the extent possible, follow the instructions given above under *Several assets*, and give as much detail as you can in a statement attached to the Form 6252.

For more information on how to complete Form 6252, see the form instructions.

Other forms. The gain from Form 6252 must be carried over and entered on another form. That form may be Schedule D, Form 4797, *Sales of Business Property*, or both. Although the references in this publication are to the Schedule D for Form 1040, the rules discussed also apply to the Schedule D's for Forms 1041 (estates and trusts), 1065 (partnerships), 1120 or 1120-A (corporations), or 1120S (S corporations). Form 4797 is used with partnership, corporation, S corporation, estate, and trust returns, as well as with individual returns.

Schedule D. If you sell property that is a capital asset and use the installment method, each year you must include the capital gain part of the installment payments from Form 6252 in your net gain or loss from the sale or exchange of capital assets. This gain or loss is reported on Schedule D (Form 1040).

If your gain from an installment sale qualified for long-term capital gains treatment in the year of sale, it will continue to qualify in later tax years when you receive and report the installment payments.

Form 4797. An installment sale of property that is used in your business or that earns you rent or royalty income sometimes results in a capital gain and sometimes in an ordinary gain and sometimes both. All or part of any gain from its disposition may be ordinary gain from depreciation. Form 4797 is used to report these transactions and to determine the amount of ordinary gain or loss and the amount of capital gain or loss.

If part of your gain on the sale is ordinary gain from depreciation (including the section 179 deduction) and part is capital gain, you must report the gain to the extent of the depreciation recapture income in the year of sale even if no payment is received.

If you dispose of more than one asset in a single transaction, you must make a separate computation for each asset so that any gain is

properly allocated between recapture income and capital gain.

Sample Forms 6252

The following two examples illustrate how to fill out Form 6252. The first example shows how the form is used in the year of sale. The second example shows how it is used in a later year. The sample filled-in forms follow these examples.

Example 1

On November 1, 1990, Mark Moore sold a lot that he had bought on February 17, 1976, for $2,650. Mark borrowed more on the lot than he had paid for it. At the time of the sale, $6,500 remained outstanding on these loans. In the sales contract, the buyer agreed to assume these loans and to pay Mark $200 a month (plus 12% interest) for 3 years. In addition, the buyer made a down payment of $1,000 on the sale.

Mark fills out his 1990 Form 6252 as follows:

Question A. Mark writes in a description of the lot he sold.

Questions B and C. Mark enters the date he acquired the lot and the date he sold it.

Question D. Because Mark sold the lot to Acme Design, a partnership of which he is a member, he checks the "Yes" box.

Question E. The property Mark sold was not a marketable security (such as a stock or a bond), so he answers "No" to this question. Because he sold the lot to a related person, he must complete Part III of the form. But because the property he sold was not a marketable security, he must complete Part III only for 1990 and the next 2 years.

Part I. Mark uses this part of the form to figure the contract price and his gross profit on the sale.

Line 1. On this line, Mark enters the selling price, $14,700. This includes the $1,000 down payment, the $7,200 (36 × $200) in monthly payments he is to receive, and the $6,500 in loans the buyer assumes.

Line 2. Mark enters the $6,500 the buyer assumes.

Line 3. Mark subtracts line 2 from line 1 and enters the difference, $8,200.

Line 4. Because he had not made any improvements to the lot, Mark's basis at the time of the sale was the lot's cost of $2,650.

Lines 5 and 6. Mark did not take depreciation deductions on the lot (land is never depreciable), so the amount on line 4 carries over to line 6.

Line 7. Mark's only selling expenses were $150 in legal fees. If he had advertised the lot for sale or paid a commission on the sale, he would include those amounts.

Line 8. Since no depreciation was claimed on the land, Mark has no income recapture.

Line 9. The total of Mark's adjusted basis in the property plus his selling expenses is $2,800.

Line 10. Mark subtracts line 9 from line 1 and enters the result, $11,900.

Line 12. The property Mark sold was not his home; therefore, he carries the amount on line 10 to line 12. This is his gross profit on the sale.

Line 13. Mark next subtracts line 9, $2,800, from line 2, $6,500. The result, $3,700, is the amount by which the assumed loans are more than Mark's basis in the property plus selling expenses. This amount is treated as a payment in the year of sale on line 16.

Line 14. The contract price is the sum of all the payments Mark will receive on the sale. This includes the down payment and all the installment payments he is scheduled to receive (line 3). It also includes the "payment" figured on line 13.

Part II. In this part Mark figures the amount of gain from the sale he must report for 1990.

Line 15. Mark's gross profit percentage for the sale is the gross profit on line 12, $11,900, divided by the contract price on line 14, also $11,900. It is, therefore, 100%.

Line 16. Mark carries the amount he treats as a payment on line 13 to this line, so that it will be counted in with the other payments he received in the year of sale.

Line 17. At the time of the sale, Mark received a down payment of $1,000. Then, in December 1990, he received his first monthly installment payment. The total payment was $272, consisting of $72 interest (one month's interest on $7,200 figured at 12% a year) and $200 principal. This is the only installment payment Mark received in 1990. He enters the total amount paid during 1990, $1,200 ($1,000 + $200), on this line. He reports the $72 interest on Form 1040.

Line 18. Mark enters $4,900, the sum of line 16 plus line 17. This is the total of all the payments he is considered to have received in 1990.

Line 19. Since 1990 is the year of sale, Mark makes no entry here.

Line 20. The gross profit percentage (line 15) for this sale is 100%. Therefore, the entire amount on line 18, $4,900, is taxable gain. Mark enters this amount on line 20.

Lines 21 and 22. Because the lot Mark sold was not depreciable property, he does not have to recapture any depreciation deductions as ordinary gain. All of his gain on the sale is long-term capital gain. He carries the amount on line 22 to line 11 of Schedule D (Form 1040) where it is included with any other long-term capital gains he may have.

Part III. Because Mark sold the lot to his partnership, a "related person," he must fill out this part of the form. But because the property he sold was not a marketable security, he must complete this part only for 1990, 1991, and 1992.

Question F. Mark enters the name, address, and employer identification number of the partnership that bought the lot.

Question G. The partnership did not sell the lot in 1990, so Mark checks the "No" box. Because he checked the "No" box, he does not have to fill out the rest of Part III.

Example 2

In December 1989, Cora Blue sold a painting she had inherited. The buyer paid her $700 down and gave her an installment note for $3,800. The note calls for quarterly payments of $530 until the $3,800 debt is paid off, in about 2 years. Each $530 payment includes interest figured at 10% a year on the outstanding debt. Cora received her first 4 payments on the note in 1990. The amount of principal and interest she received in each payment is given in the table below:

Payment	Interest	Principal
First	$ 95.00	$ 435.00
Second	84.13	445.87
Third	72.98	457.02
Fourth	61.55	468.45
	$313.66	$1,806.34

Cora must report the $313.66 in interest as ordinary income on her Form 1040. She reports the $1,806.34 in principal on Form 6252 as follows:

Question A. Cora states that the property she sold was an oil painting.

Questions B and C. She enters the date she acquired the painting (through inheritance) and the date she sold it.

Question D. The buyer was not related to Cora, so she checks the "No" box.

Question E. Because she checked "No" to question D, Cora does not have to answer this question or fill out Part III of the form.

Part I. Cora completed Part I of her Form 6252 for the year of sale, 1989. She does not fill it out for the remaining years of the installment sale.

Part II. This is the only part of Form 6252 that Cora fills out.

Line 15. On her 1989 Form 6252, Cora figured her gross profit percentage to be 22.7%. She uses this same percentage on her 1990 Form 6252.

Line 16. Since this is not the year of sale, Cora enters zero on this line.

Line 17. Cora enters the total amount (minus interest) that she received on the sale in 1990, $1,806.34.

Line 18. The amount on line 17 carries over to line 18.

Line 19. Before 1990, Cora had received only the $700 down payment on the sale.

Line 21. Cora next multiplies the gross profit percentage of 22.7% (line 15), by the amount she was paid in 1990 (line 18), $1,806.34. The result, $410.04, is the amount of gain she had on the sale in 1990.

Lines 21 and 22. Cora did not use the painting in a business, so it was not depreciable and the recapture rules do not apply. The amount on line 20 carries over to line 22. Her gain is long-term capital gain. She carries the amount on line 22 to line 11 of Schedule D (Form 1040), where it is included with any other long-term capital gains she may have.

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ See separate instructions. ▶ Attach to your tax return.

Use a separate form for each sale or other disposition of property on the installment method.

OMB No 1545-0228

1990

Attachment Sequence No 79

Name(s) shown on tax return: Mark Moore

Identifying number: 123-00-6789

A Description of property ▶ Undeveloped Lot

B Date acquired (month, day, and year) ▶ 2 / 17 / 76 C Date sold (month, day, and year) ▶ 11 / 1 / 90

D Was the property sold to a related party after May 14, 1980? (See Instructions.) ☑ Yes ☐ No

E If the answer to D is "Yes," was the property a marketable security? (If "Yes," complete Part III. If "No," complete Part III for the year of sale and for 2 years after the year of sale.) ☐ Yes ☑ No

Part I Gross Profit and Contract Price (Complete this part for the year of sale only.)

1	Selling price including mortgages and other debts. (Do not include interest whether stated or unstated.)		1 14,700
2	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	2 6,500	
3	Subtract line 2 from line 1	3 8,200	
4	Cost or other basis of property sold	4 2,650	
5	Depreciation allowed or allowable	5 -0-	
6	Adjusted basis. Subtract line 5 from line 4	6 2,650	
7	Commissions and other expenses of sale	7 150	
8	Income recapture from Form 4797, Part III. See Instructions	8 -0-	
9	Add lines 6, 7, and 8		9 2,800
10	Subtract line 9 from line 1. If zero or less, do not complete the rest of this form		10 11,900
11	If the property described in question A above was your main home, enter the total of lines 9g and 15 from Form 2119. Otherwise, enter -0-		11 -0-
12	Gross profit. Subtract line 11 from line 10		12 11,900
13	Subtract line 9 from line 2. If zero or less, enter -0-		13 3,700
14	Contract price. Add line 3 and line 13		14 11,900

Part II Installment Sale Income (Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.)

15	Gross profit percentage. Divide line 12 by line 14. (For years after the year of sale, see Instructions.)		15 1.00
16	**For year of sale only**—enter amount from line 13 above; otherwise, enter -0-		16 3,700
17	Payments received during year. See Instructions. (Do not include interest whether stated or unstated.)		17 1,200
18	Add lines 16 and 17		18 4,900
19	Payments received in prior years. See Instructions. (Do not include interest whether stated or unstated.)	19	
20	Installment Sale Income. Multiply line 18 by line 15		20 4,900
21	Part of line 20 that is ordinary income under recapture rules. See Instructions		21 -0-
22	Subtract line 21 from line 20. Enter here and on Schedule D or Form 4797		22 4,900

Part III Related Party Installment Sale Income (Do not complete if you received the final payment this tax year.)

F Name, address, and taxpayer identifying number of related party: Acme Design W. Main Street Smalltown, NY 12899 10-7654321

G Did the related party, during this tax year, resell or dispose of the property ("second disposition")? ☐ Yes ☑ No

H **If the answer to question G is "Yes," complete lines 23 through 30 below unless one of the following conditions is met (check only the box that applies).**

☐ The second disposition was more than two years after the first disposition. If this box is checked, enter the date of disposition (month, day, year) ▶ / /

☐ The first disposition was a sale or exchange of stock to the issuing corporation.

☐ The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition.

☐ The second disposition occurred after the death of the original seller or buyer.

☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See Instructions.

23	Selling price of property sold by related party	23
24	Enter contract price from line 14 for year of first sale	24
25	Enter the **smaller** of line 23 or line 24	25
26	Total payments received by the end of your 1990 tax year. Add lines 18 and 19	26
27	Subtract line 26 from line 25. If zero or less, enter -0-	27
28	Multiply line 27 by the gross profit percentage on line 15 for year of first sale	28
29	Part of line 28 that is ordinary income under recapture rules. See Instructions	29
30	Subtract line 29 from line 28. Enter here and on Schedule D or Form 4797	30

For Paperwork Reduction Act Notice, see separate instructions.

Form 6252 (1990)

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ See separate Instructions. ▶ Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.

OMB No 1545-0228

1990

Attachment Sequence No 79

Name(s) shown on tax return: Cora Blue

Identifying number: 095-00-0000

A Description of property ▶ Oil Painting

B Date acquired (month, day, and year) ▶ 7 / 3 / 85 C Date sold (month, day, and year) ▶ 12 / 11 / 89

D Was the property sold to a related party after May 14, 1980? (See Instructions.) ☐ Yes ☑ No

E If the answer to D is "Yes," was the property a marketable security? (If "Yes," complete Part III. If "No," complete Part III for the year of sale and for 2 years after the year of sale.) ☐ Yes ☐ No

Part I Gross Profit and Contract Price *(Complete this part for the year of sale only.)*

1	Selling price including mortgages and other debts. (Do not include interest whether stated or unstated.)		1	
2	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	2		
3	Subtract line 2 from line 1	3		
4	Cost or other basis of property sold	4		
5	Depreciation allowed or allowable	5		
6	Adjusted basis. Subtract line 5 from line 4	6		
7	Commissions and other expenses of sale	7		
8	Income recapture from Form 4797, Part III. See Instructions	8		
9	Add lines 6, 7, and 8		9	
10	Subtract line 9 from line 1. If zero or less, do not complete the rest of this form		10	
11	If the property described in question A above was your main home, enter the total of lines 9g and 15 from Form 2119. Otherwise, enter -0-		11	
12	Gross profit. Subtract line 11 from line 10		12	
13	Subtract line 9 from line 2. If zero or less, enter -0-		13	
14	Contract price. Add line 3 and line 13		14	

Part II Installment Sale Income *(Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.)*

15	Gross profit percentage. Divide line 12 by line 14. (For years after the year of sale, see Instructions.)		15	.227
16	**For year of sale only**—enter amount from line 13 above; otherwise, enter -0-		16	-0-
17	Payments received during year. See Instructions. (Do not include interest whether stated or unstated.)		17	1,806 34
18	Add lines 16 and 17		18	1,806 34
19	Payments received in prior years. See Instructions. (Do not include interest whether stated or unstated.)	19 700		
20	Installment Sale Income. Multiply line 18 by line 15		20	410 04
21	Part of line 20 that is ordinary income under recapture rules. See Instructions		21	-0-
22	Subtract line 21 from line 20. Enter here and on Schedule D or Form 4797		22	410 04

Part III Related Party Installment Sale Income *(Do not complete if you received the final payment this tax year.)*

F Name, address, and taxpayer identifying number of related party

G Did the related party, during this tax year, resell or dispose of the property ("second disposition")? ☐ Yes ☐ No

H **If the answer to question G is "Yes," complete lines 23 through 30 below unless one of the following conditions is met (check only the box that applies).**

☐ The second disposition was more than two years after the first disposition. If this box is checked, enter the date of disposition (month, day, year) ▶ / /

☐ The first disposition was a sale or exchange of stock to the issuing corporation.

☐ The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition.

☐ The second disposition occurred after the death of the original seller or buyer.

☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See Instructions.

23	Selling price of property sold by related party	23	
24	Enter contract price from line 14 for year of first sale	24	
25	Enter the **smaller** of line 23 or line 24	25	
26	Total payments received by the end of your 1990 tax year. Add lines 18 and 19	26	
27	Subtract line 26 from line 25. If zero or less, enter -0-	27	
28	Multiply line 27 by the gross profit percentage on line 15 for year of first sale	28	
29	Part of line 28 that is ordinary income under recapture rules. See Instructions	29	
30	Subtract line 29 from line 28. Enter here and on Schedule D or Form 4797	30	

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